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No. 80-1884

IN THE

Supreme Court of the United States

OCTOBER TERM 1980

MEMOREX CORPORATION, et al.,

Petitioners,

vs.

INTERNATIONAL BUSINESS MACHINES CORPORATION,

Respondent.

On Petition for Writ of Certiorari to
The United States Court of Appeals
For the Ninth Circuit

MOTION OF TRANSAMERICA COMPUTER COMPANY, INC. FOR LEAVE TO FILE *AMICUS CURIAE* BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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Transamerica Computer Company, Inc. ("Transamerica") hereby moves for leave to file an *amicus curiae* brief, a copy of which is appended hereto as Appendix A, in support of the Petition for Writ of Certiorari in the above-entitled case. Petitioners Memorex Corporation, Memorex Sales and Service Corporation and ILC Peripherals Leasing Corporation ("Memorex") have consented to the filing of this brief. Respondent International Business Machines Corporation ("IBM") has refused consent, thus making necessary this application for leave to file.

INTEREST OF TRANSAMERICA

The interest of Transamerica in this case is as follows:

1. The decision of the Ninth Circuit now before the Court for review is a *per curiam* opinion based solely on the authority of the earlier panel decision in *CalComp.*[1] *CalComp* and *Memorex* are two of a series of monopoly cases brought against IBM in the Ninth Circuit in late 1973 and early 1974. These cases were consolidated for pretrial by the Judicial Panel on Multidistrict Litigation and until early 1977 were assigned to a single judge for all purposes pursuant to an intracircuit transfer.[2] Transamerica is plaintiff in one such case (*Transamerica* v. IBM).

CalComp, the first M.D.L. 163 case to be tried, resulted in a directed verdict for IBM on February 11, 1977.[3] The jury trial of *Transamerica* v. *IBM* began on December 4, 1978.[4] Several months later, at the close of Transamerica's case-in-chief, and again at the close of the evidence, motions for directed verdict were made and each was denied.

On June 22, 1979, the Friday preceding the Monday on which closing arguments were to begin, and after jury instructions were nearly settled, the Ninth Circuit's panel opinion in *CalComp* was received. The court delayed arguments and made substantial revisions in the instructions.

As a result of the *CalComp* decision, the jury was instructed that, with one limited exception, the *only* relevant "conduct" issue was whether IBM's prices were above cost, either because IBM thought they would be or because they turned out to be.

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[1] *California Computer Products, Inc.* v. *International Business Machines Corp.*, 613 F.2d 727 (9th Cir. 1979).

[2] Chief Judge Ray McNichols of the District of Idaho initially presided over the M.D.L. 163 cases. *See In Re IBM Peripheral EDP Devices Antitrust Litigation*, 375 F. Supp. 1376 (J.P.M.L. 1974).

[3] *CalComp* settled after judgment on the directed verdict was affirmed and CalComp's petition for rehearing in banc was denied. Thus no petition for certiorari was filed.

[4] Judge Robert H. Schnacke of the Northern District of California presided.

The jury concluded that IBM possessed monopoly power in each of the markets alleged by Transamerica. But faced with internally inconsistent and legally incorrect instructions on conduct, the jury was unable to agree either on whether IBM had willfully acquired or maintained that power or whether its conduct amounted to an attempt to monopolize. After 11 days of deliberations, the jury was discharged and, under a pretrial agreement, the case was submitted to the court.

On October 18, 1979, the court filed its opinion in favor of IBM despite its conclusions that IBM's "predominant intent" in adopting one challenged product design "was undoubtedly to preclude or delay PCM competition and gain a competitive advantage," and that "the only purpose served and the only effect of the degradation [of another planned product] was the preclusion of competition."[5] Judgment was entered on October 31, 1979. After post-trial motions were made and, with minor exceptions denied, a revised opinion was filed on December 20, 1979. Transamerica filed a timely notice of appeal and, after lengthy delays in completion of the record on appeal, filed its opening brief in the Ninth Circuit on February 24, 1981.

2. This Court's decision in the *Memorex* case, should it decide to hear it, will settle or at least clarify the confused and conflicting views of the lower courts on the legal standard applicable to a monopolist under Section 2 of the Sherman Act. That decision will undoubtedly have an important bearing on the ultimate resolution of Transamerica's case. Under these circumstances, Transamerica has a significant interest in Memorex's petition and Transamerica's views should, it respectfully submits, be taken into account by this Court.

3. That Transamerica's views should be taken into account is underscored by the fact that, but for the discovery intransigence of IBM, Transamerica's case would have been the first of the M.D.L. 163 cases to be tried and receive appellate review. Because of the assignment of all cases to a single judge for pretrial and trial, and because it was thought impractical to consolidate all M.D.L. 163 cases for a single trial, each

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[5] *Transamerica Computer Co., Inc.* v. *International Business Machines Corp.*, 481 F. Supp. 965, 1005, 1007 (N.D. Cal. 1979).

plaintiff's discovery requests and trial setting was affected by each of the other cases. At its urging, Transamerica's case was calendared to be tried first, with *CalComp* and then *Memorex* to follow.

Beginning in 1975, Transamerica's discovery focused on IBM's projected and actual costs and profits on the product actions in question—IBM's principal antitrust defense since *Telex*.[6] But because IBM stridently resisted Transamerica's discovery into these areas—a remarkable tactic, given what IBM has represented on this subject to the Tenth Circuit and to this Court—Transamerica was forced to forego its early trial date when other M.D.L. 163 plaintiffs acquiesced in going to trial without that discovery. Plaintiffs in the earlier-tried cases thus were not well-placed to refute IBM's "substantially profitable" defense and, when that defense carried the day again (as it plainly did in *CalComp*), the outcome substantially affected the jury instructions in Transamerica's case.

The same judicially-determined similarities that led to Transamerica's consolidation in M.D.L. 163, the attendant discovery and trial setting limitations imposed on Transamerica by that consolidation, and the effect on its case of the results in earlier-tried cases demonstrate the propriety of its *amicus curiae* status.

THE INADEQUACY OF PRESENTATION OF KEY ISSUES

The questions presented by this case focus on the propriety of applying a cost-based *per se* test of legality to the conduct of a monopolist under Section 2 of the Sherman Act. Transamerica painstakingly investigated IBM's claims of substantial profitability in connection with the challenged pricing actions for more than five years and, as discussed in the appended brief, proved those claims to be grossly misleading. It has grappled with the economic and legal issues presented by the

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[6] *Telex Corp.* v. *International Business Machines Corp.*, 367 F. Supp. 258 (N.D. Okla. 1973), *rev'd*, 510 F.2d 894 (10th Cir.), *cert. dismissed*, 423 U.S. 802 (1975).

adoption of cost-based tests throughout that period, whereas those issues have only recently come into focus in the instant case. For these reasons, Transamerica believes that, without its record, these issues will not adequately be presented by the parties.

Dated: June 3, 1981

Respectfully submitted,

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APPENDIX A

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Transamerica Computer Company, Inc. ("Transamerica") submits this *amicus curiae* brief in support of Memorex's petition for writ of certiorari.

I.

INTEREST OF *AMICUS*

Transamerica's appeal is pending before the Ninth Circuit (No. 80-4048), following the trial of its case against IBM for

violation of Section 2 of the Sherman Act.[1] Transamerica's case raises many of the same fundamental issues decided by a panel of the Ninth Circuit in *California Computer Products, Inc.* v. IBM [2], adopted *per curiam* by the court below in this case. But more than any other earlier-tried IBM Section 2 case, Transamerica's case addresses directly IBM's pricing actions and its margins of profits and losses.[3] Transamerica's case focuses primarily on the core issue raised by the petition in this case—should Section 2 cases be decided under the standards first enunciated in Judge Hand's decision in *Alcoa*,[4] since refined and reaffirmed by this Court,[5] or instead, as the court below did, by applying mechanistic cost-based *per se* rules?

A. Description of *Amicus*

Transamerica, a wholly-owned subsidiary of Transamerica Corporation, began its participation in the computer industry in 1968. Its initial business was purchasing computer equipment from manufacturers and leasing it to users, thus becoming known as an "independent third party leasing company"—to distinguish it from manufacturers who also leased to users. The record in *Transamerica* v. *IBM* showed that Transamerica planned to enter other areas of the industry, including manufacturing. As a direct result of IBM's conduct, however, Transamerica is no longer an active participant in the computer industry.[6]

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[1] *Transamerica Computer Co., Inc. v. International Business Machines Corp.* The district court opinion is at 481 F. Supp. 965 (N.D. Cal. 1979).

[2] 613 F.2d 727 (9th Cir. 1979)("*CalComp*").

[3] The other cases we refer to are *Telex (Telex Corp.* v. *IBM*, 367 F.Supp. 258 (N.D. Okla. 1973), *rev'd*, 510 F.2d 894 (10th Cir.), *cert. dismissed*, 423 U.S. 802 (1975)), *CalComp* and *Memorex*. Telex's petition in this Court was dismissed when the case settled.

[4] *United States* v. *Aluminum Co. of America*, 148 F.2d 416 (2nd Cir. 1945).

[5] *American Tobacco Co.* v. *United States*, 328 U.S. 781 (1946); *United States* v. *Griffith*, 334 U.S. 100 (1948); *Schine Chain Theatres* v. *United States*, 334 U.S. 110 (1948); *United States* v. *United Shoe Machinery Corp.*, 110 F.Supp. 295 (D. Mass. 1953), *aff'd per curiam*, 347 U.S. 521 (1954); *United States* v. *Grinnell Corp.*, 384 U.S. 563 (1966); *Otter Tail Power Co.* v. *United States*, 410 U.S. 366 (1973).

[6] Reflecting its exit from the computer industry, Transamerica Computer Company's name was changed to Transamerica Equipment Leasing Co. on January 11, 1980.

When it was in the industry Transamerica was a pro-competitive force, both as a supplier to end users and as a purchaser from manufacturers. Because many users lack the financial resources to buy computers and because IBM historically either refused to sell or discouraged sales, leasing has always been the prevalent form of computer equipment acquisition. The record in *Transamerica* v. *IBM* showed that before the entry of companies such as Memorex, Telex, CalComp and Transamerica, IBM fixed its lease prices at monopoly levels, except where temporary price cuts were used to exclude entrants on the fringes of its markets.

For a time in the late 1960's and early 1970's independent leasing companies like Transamerica offered equipment to users at prices below those fixed by IBM. Before IBM drove it from these markets, Transamerica had purchased some $200 million of computer equipment and placed it on lease with customers on terms more favorable than those offered by IBM. About one-third of Transamerica's total purchases was made up of peripheral devices (tapes and disks) plug-compatible to IBM central processing units (CPUs). These devices were equivalent or superior to the counterpart IBM devices in function and performance. Thus, Transamerica introduced an element of competition to an industry of great national importance and of equally great structural dislocation.

In addition to offering users superior products at lower rents leasing companies provided needed funds to fledgling manufacturers. The lease nature of the computer business means that any new entrant must wait years—and be able to survive and grow in the interim—before it recovers its costs and begins to be profitable. The risks of investment in development, production, marketing and service were risks shared by the leasing companies, such as Transamerica, when they entered into purchase agreements with new manufacturers.

Before IBM eliminated them, independent leasing companies thus represented a significant source of capital to companies seeking to break into the lease-oriented, capital intensive markets dominated by IBM. IBM recognized such companies as the means by which new manufacturers could

enter the peripheral markets and ultimately the systems market. Accordingly, it undertook a course of conduct that resulted in the elimination or containment of Memorex, Telex, CalComp, Transamerica and other companies who sought to enter these monopolized markets.

B. The Related, Earlier-Tried Cases.

The well-established legal standard for assessing monopoly conduct has undergone a radical reformulation, at IBM's urging, in the earlier-tried IBM cases. Thus, the Ninth Circuit's *CalComp* (now *Memorex*) opinion focused not on whether IBM's conduct was a "willful maintenance of monopoly power" or whether it "unnecessarily excluded competition," but instead on whether the pricing aspects of IBM's conduct were "profitable."

It is evident that the earlier-tried cases, particularly the panel decision in *CalComp*, have affected Transamerica's case. The day after jury instructions were all but settled in *Transamerica* v. *IBM*, the *CalComp* decision was received. The district court then revised its jury instructions to reflect that opinion. As a result, the instructions as given were plainly at variance with the Section 2 standard established by this Court.

Simply stated, Transamerica's interest in this case stems from its conviction that the effective repeal of Section 2 as reflected in the earlier-tried IBM cases must be corrected.

II.

SUMMARY OF ARGUMENT

Can the dominant firm in an industry intentionally ruin competitors, just as they are entering the market, by a succession of product, pricing and marketing manipulations, and escape scrutiny under the antitrust laws? Can it do so when its conduct is the direct product of special studies of these fledgling competitors designed to determine exactly what is necessary to

drive them to their "death level"[7]—and the acts succeed in doing just that? Can it be legally irrelevant that such conduct represents a willful maintenance of monopoly power? Can such a company do all that—expressly intend to ruin its competitors, succeed in doing so, deprive consumers of competitive choices and emerge with its monopoly intact—and yet escape any antitrust consequences simply because some courts ask only whether its prices were below "cost"?

These are not attention-getting overstatements—they are instead the very questions *CalComp*, *Memorex* and *Transamerica* present. Each is answered in the affirmative by the panel opinions in *CalComp* and in this case.

Transamerica respectfully submits that under established Section 2 law, those decisions are wrong. Accordingly, the petition should be granted to correct these fundamental errors and, because its record will materially assist the Court in resolving these issues, further proceedings should be deferred until Transamerica's case reaches this Court.

III.

ARGUMENT IN SUPPORT OF GRANTING THE WRIT

In the eight years since this Court last addressed Section 2, in *Otter Tail Power Co.* v. *United States*,[8] certain lower courts, including the panel in *CalComp*, have adopted a cost-based *per se* rule of legality. This unprecedented *per se* rule, endorsed without the benefit of records sufficient to test its soundness, has been the subject of a constant stream of criticism by leading economists and antitrust scholars. If this rule remains the law, Section 2 will be wholly ineffective as a check against monopolistic pricing.

[7] The very words used in an IBM study which shows, along with other documents, IBM's intent to ruin these new entrants. Another IBM study analyzes the effect of IBM's long-term leases and concludes they will make each of IBM's fledgling competitors a "dying company."

[8] 410 U.S. 366 (1973).

A. CalComp's Exclusive Reliance On A Cost-Based Test Is Irreconcilable With Decisions Of Both This Court And Other Panels Of The Ninth Circuit.

Decisions of both this Court and of the Ninth Circuit on the "conduct" element of monopolization leave no doubt that *CalComp* is at odds with established Section 2 law. In summary, those cases hold that

—A monopolist violates Section 2 by conduct that "unnecessarily exclude[s]" competition[9] or that makes "entry into the market more difficult and costly, to the detriment of competition generally."[10]

—A monopolist's *use* of its power, whether or not lawfully acquired, "to foreclose competition, to gain a competitive advantage, or to destroy a competitor, is unlawful."[11]

—Since price cuts by a monopolist, standing alone, are ambiguous, "facts and circumstances must be adduced to show that it [price cutting] was in purpose or effect employed as an instrument of monopoly power."[12]

—"Wrongful" or "predatory" conduct is not an essential part of a monopolization claim.[13]

CalComp and *Memorex* are clear departures from the rules of these cases.

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[9] *United States* v. *United Shoe Machinery Corp., supra,* 110 F.Supp. at 344-45; *Greyhound* v. *International Business Machines Corp.,* 559 F.2d 488, 498 (9th Cir. 1977), *cert. denied,* 443 U.S. 1040 (1978); *Purex* v. *Procter & Gamble,* 596 F.2d 881, 890 (9th Cir. 1979); *Sherman* v. *British Leyland Motors, Ltd.,* 601 F.2d 429, 454 (9th Cir. 1979).

[10] *Hunt-Wesson Foods, Inc.* v. *Ragu Foods,* 627 F.2d 919, 927 (9th Cir. 1980).

[11] *United States* v. *Griffith, supra,* 334 U.S. at 107; *Otter Tail Power Co.* v. *United States, supra,* 410 U.S. at 1029.

[12] *Schine Chain Theatres* v. *United States, supra,* 334 U.S. at 120-21. *See also United States* v. *Grinnell Corp., supra,* 384 U.S. at 576 (condemning, among other things, a monopolist's "pricing practices that contained competitors.").

[13] *United States* v. *United Shoe Machinery Corp., supra,* 110 F.Supp. at 345 ("United is denied the right to exercise effective control of the market by business policies that are not the inevitable consequences of its capacities or its natural advantages. That those policies are not immoral is irrelevant."); *Greyhound, supra,* 559 F.2d at 498.

B. The Adoption Of Cost-Based *Per Se* Legal Tests In Section 2 Cases Encourages The Very Evil Section 2 Proscribes.

The notion that mechanistic cost-based rules could preempt reasoned analysis of monopoly conduct got its start in a 1975 law review article by Areeda and Turner.[14] Their proposal was that any price above marginal or average variable cost should be *per se* legal, even for a monopolist.

The article recognized that a firm selling at "limit prices," *i.e.*, prices above full costs but less than the short-run profit-maximizing price, would be doing so for predation purposes:

> When a monopolist sells at a price at or above average cost, but could earn higher short run profits at a higher price, the necessary element of predation is presumably present. *Id.* at 704.

Even though the authors recognize that such prices would deter new entry or destroy rivals and that, in the absence of limit pricing, entry would drive prices down and might "lead to more invention and innovation and a quicker dispersion of existing innovations throughout the economy," *id.* at 705, they conclude that such pricing should be *per se* legal. *Id.* at 704-09. While conceding that their rule permits the destruction of *equally* efficient firms, they could "see no satisfactory method of eliminating this risk." *Id.* at 711. The authors reject any constraint on a monopolist's use of limit pricing because, according to them, the long-run advantages of prohibiting it are "speculative." *Id.* at 706.

The Areeda-Turner approach has been criticized and discredited by economists and antitrust scholars alike. Economists reject it because it focuses exclusively on the short run

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[14] Areeda & Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 *Harv. L. Rev.* 697 (1975).

and wholly ignores long-run consequences.[15] Lawyers—practioners and academicians—reject it because it is mechanistic and, since it purports to be the *exclusive* test, because it ignores highly relevant evidence.[16] As one authority puts it, the obvious vice of the Areeda-Turner proposal is not just that it has selected the wrong costs but that cost-based tests "without regard to the circumstances" ignore the harmful economic effects of "strategic uses of predatory pricing."[17]

The fatal flaws of cost-based rules are their exclusive focus on the short run and their assumption that real world markets are static. In most markets, including the peripherals markets involved in this case, one firm "gets there first." By being first, that firm experiences the advantages of the "learning curve," *i.e.*, it has the opportunity to become efficient, exact a premium price for its product, and enjoy the attendant high profits. New entrants are then attracted to this market. Initially they may not be as "efficient" as the established firm. But because of the entrenched market position of the older firm, the new entrants must often discount the prices of their products.

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[15] *E.g.*, Sherer, *Predatory Pricing and the Sherman Act: A Comment*, 89 *Harv. L. Rev.* 868 (1976); Scherer, *Some Last Words on Predatory Pricing*, 89 *Harv. L. Rev.* 901 (1976); R. Posner, *Antitrust Law: An Economic Perspective 191-93 (1976); Williamson, Predatory Pricing: A Strategic and Welfare Analysis*, 87 *Yale L. J.* 284 (1977); Baumol, *Quasi-Permanence of Price Reductions: A Policy for Prevention of Predatory Pricing*, 89 *Yale L. J.* 1 (1979); Joskow & Klevorick, *A Framework for Analyzing Predatory Pricing Policy*, 89 *Yale L. J.* 213 (1979).

[16] *E.g.*, *The Report of the National Commission for the Review of Antitrust Laws and Procedures* (1979) found such a cost-based test "too restrictive" and recommended a "more flexible analytical approach."; Sullivan, *Antitrust, Microeconomics and Politics: Reflections on Some Recent Relationships*, 68 *Calif. L. Rev.* 1, 3 (1980)("Recent predatory pricing cases have a similar thrust. The courts specify an objective norm that they think will discriminate between price cutting that hurts allocative efficiency in the short run and price cutting that does not. *This norm then becomes the sole legal test. In a vain search for precision, objectivity and efficiency, courts use simplistic, short run, static theory to solve complex, long run, strategic problems.*")(emphasis added); Fox, *A Clarion Universe of Microeconomic Policy*, 54 *N.Y.U.L. Rev.* 466 (1979); Flynn, *Monopolization Under the Sherman Act: The Third Wave and Beyond*, 26 *Ant. Bull.* 1 (1981).

[17] Williamson, *Williamson on Predatory Pricing II*, 88 *Yale L. J.* 1183 (1979).

Under a cost-based rule making price cuts by a monopolist *per se* legal, these new entrants—faced with a short-run cost disadvantage *and* the need to discount—can be eliminated by price cuts that, for the monopolist, are not necessarily below cost. Such a rule simply has no place in the antitrust laws.

In the most recent and comprehensive commentary on current Section 2 law, Professor Flynn had this to say about the cost-based rule applied by the court in *Transamerica*:

> Sorting out procompetitive from anticompetitive conduct through the use of shorthand fomulae relying upon "objective" criteria rooted in an artificial and unrealistic model of one school of economic thought is scarcely empirical or inductively based decisionmaking. About all that may be said for it, is that it gets rid of difficult cases relatively rapidly even though the process may not accurately determine whether there has been a violation of the law or not or one that ought to be compensable under the antitrust laws.[18]

Any static, short-run, cost-based test is nothing less than a license to maintain monopolies. It plainly invites use of that license against new entrants, before they can become "efficient." Such a rule totally ignores one of the most fundamental precepts of the American legal system: unchecked power is inevitably abused and exploited.

C. The Presumed "Objectivity" And Easy Application Of Cost-Based Tests Is Wholly Fanciful.

A further vice of reliance on any cost-based rule is that "cost" is an elusive concept. What it is and how it is defined depend in large part on why the information is needed and the time over which cost is measured.[19]

To determine historic profitability, costs are subtracted from revenues. Here the markets are largely lease markets, where revenues and costs are *projected*. In projecting profit-

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[18] Flynn, *supra*, 26 *Ant. Bull.* at 73-74.

[19] The accountants who testified for IBM and Transamerica at Transamerica's trial agreed on this.

ability, known and estimated costs are subtracted from projected revenues.

The variables introduced by estimating some costs and projecting all revenues make profit projections uncertain at best when a firm is selling a single product. But to project the profitability, product-by-product, of a multi-product firm requires not only the aggregation of known and estimated costs and projected revenues for each product but also the allocation of those costs among the several products to be offered. This process becomes even more complex when the products are *leased* rather than sold because products that are leased incur costs and produce revenues over time, rather than at the moment of sale.

IBM itself acknowledged the unreliability of such projections when it suited its then-purpose to argue in *Greyhound* v. *IBM, supra,* that in these lease markets "both future rental income and future expenses are unknown and highly speculative."[20] It is at least ironic that the lower courts have exonerated IBM on the basis of "costs" and "profitability" derived from such projections.

Moreover, an accounting system suitable for firm-wide historic reporting may be entirely unsuitable for yielding the information cost-based tests contemplate. That is especially so here because IBM's system of projecting costs and revenues is extremely flexible and permits almost any result desired.

IBM is a multi-product firm. Direct production costs are a small part of its total costs, while indirect costs, *e.g.,* marketing, indirect engineering and manufacturing, and general administrative ("G&A") are a much larger part.[21] To project profitability on given products, IBM allocates indirect costs to those products by a series of "apportionments." IBM's system estimates future company-wide revenue, direct and indirect costs, and determines the mathematical relationship of each to the other. Indirect manufacturing and engineering costs for a

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[20] 599 F.2d at 506.

[21] The financial procedures described immediately below are set forth in IBM's Financial Procedures Manual, and are part of the record in *Transamerica* v. *IBM.*

specific product are then determined by applying fixed percentages (calculated from the company-wide figures) to the direct manufacturing and engineering costs for that product. Other indirect costs charged to that product (marketing, G&A) are determined by taking a fixed percentage of the projected *revenue* from that product. These allocations of indirect costs account for *over 60%* of the total costs charged to a product. The "revenue" apportioned costs alone represent nearly 60% of total costs.

An IBM financial analyst projecting the profitability of a product obtains from an IBM forecaster the projected number of units to be placed.[22] The analyst obtains estimates of direct engineering and manufacturing costs. With this information, assumptions about prices, and the apportionment percentages, projected profitability is then "calculated." For example, if 10 units are forecast to be placed for a total of 10 months at a price of $1 per month, direct engineering costs of $4 and direct manufacturing costs are $23, a projected "profit" statement for that product would look like this:

Revenue (10 units at $1 month for 10 months)		$100
Less:		
Direct Engineering	$ 4	
Engineering Apportionment (25% of direct engineering costs	$ 1	
Direct Manufacturing	$23	
Manufacturing Apportionment (8.7% of direct manufacturing costs)	$ 2	
Revenue Apportionment (40% of revenue)	$40	
Total Costs	$70	
Profit		$ 30
Profit %		30%

[22] A "forecaster" uses forecast assumptions, including a description of the product, delivery schedules, target prices, physical life, competing products, follow-on products and other information, to forecast the quantities and timing of customer acceptances and removals of a product. A "financial analyst" or "pricer" uses the product forecast and estimates of direct costs to project the revenues, costs and profits of a proposed product or pricing action, given a certain price level.

Now assume that to keep the same number of units on rent for the same period IBM cuts price by 40%. Since volume remains the same, revenue drops by 40%. But costs automatically disappear:

Revenue		$ 60
Less:		
Direct Engineering	$ 4	
Engineering Apportionment	$ 1	
Direct Manufacturing	$23	
Manufacturing	$ 2	
Revenue Apportionment	$24	
Total Costs	$54	
Profit		$ 6
Profit %		10%

Even though the drop in revenue from the price cut ($40) exceeds the pre-price cut profit ($30), instead of showing a loss, the product shows a 10% profit! This is so because many of the costs allocated to the product and tied to revenue simply disappear under IBM's financial procedures.

The obvious flexibility of such a system makes ludicrous placing *any* reliance on a cost-based test, much less exclusive reliance. Yet that is exactly what has happened in these IBM Section 2 cases.

The record in *Transamerica* shows that, in a related context, when IBM felt disadvantaged by AT&T's similar cost allocation technique, it attacked AT&T's revenue apportionments as being unreliable and excessively flexible. Thus, in a Federal Communications Commission proceeding involving the accounting systems of telephone companies, IBM filed a brief complaining about AT&T's use of a revenue apportionment system which allocated 17% of its costs. IBM's point there was that such a system is so flexible that AT&T could subsidize its non-regulated activities by artificially transferring costs to its regulated activities. Obviously the risk of distortion of true costs is almost four times greater under IBM's system: IBM allocates almost 60% of its costs by the revenue apportionment

system while the telephone company was apportioning 17% of its costs by revenue.[23]

A pricing system that allocates substantial costs by revenue may serve a company's purpose when the company consistently sets prices high, as IBM historically did. But such a system is demonstrably unreliable in producing trustworthy cost and profit data when the company departs from its historic pricing practices and severely cuts price on selective products.

Any reliance on IBM's system because it was "consistently" followed, even if that were correct, begs the question. If courts are to use a cost-based test to determine predatory pricing then the question is whether IBM's financial analysis system provides reasonably accurate cost and profit data. IBM answered this question with a loud "NO" when it attacked AT&T's *less* flexible system as being *too* flexible to allocate cost data correctly. Hence if IBM's cost allocation system is too flexible, and its estimates of "future rental income and future expenses are unknown and highly speculative"—as IBM admitted in *Greyhound*[24]—surely it is foolish to rely on the "costs" yielded by IBM's accounting system to determine whether its conduct is anticompetitive.

Finally, it must not be overlooked that a defendant in a monopolization case, charged with "predatory pricing" and defending its actions on the basis that they were "profitable," does not readily yield up data from which its costs, revenues and profit margins might be determined. Although Transamerica centered much of its attention on such data, it is an

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[23] The acknowledgement of IBM's Director of Financial Analysis of the extreme flexibility IBM has in selecting "cost" is memorialized in an exhibit in the *Transamerica* record. In advising IBM's top management committee regarding the then-current Federal Price Control Guidelines (which limited markups for new products to existing markups), he confirmed that, for IBM, "the definition of 'cost' can vary in accordance with the hardware included, method of recovery for system control and programming, maintenance considerations and time periods used for analysis." For IBM's then-unannounced system 370 Models 158 and 168, "depending on the variables utilized . . . planned prices could vary as much as –20% to + 15% in trying to establish a relationship with System 370 markup."

[24] *Greyhound, supra*, 559 F.2d at 506.

understatement to say that IBM did not readily produce it.[25] After several court orders, IBM did produce millions of pages of "financial" documents. But when asked what the documents were, how the data was obtained, how it was used, and what was relied on by management, IBM stonewalled. IBM forecasters and financial analysts said they did not recall documents they had worked on, did not recall how they were prepared, and did not recall how the forecasts of product placements—perhaps the most important item in IBM's projections of profitability—were done. Transamerica ultimately obtained answers to some of these questions by court-ordered depositions under Rule 30(b)(6), but its experience proved that an examination of costs and profit data is difficult, time-consuming and expensive at best, and, at worst, impossible.[26] It is demonstrably not the easy, certain and reliable inquiry that proponents of cost-based tests assume.[27]

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[25] The record in *Transamerica* reveals that Transamerica's attempts to find out IBM's real costs and profits was lengthy and tortured.

[26] IBM was permitted to present so-called "actual" cost and profit data at Transamerica's trial despite discovery representations such as that below in response to Transamerica's attempts to obtain such data:

> As IBM interprets this interrogatory [No. 379-2], IBM does not have and has never had information that would yield *actual* profit and profit percent derived from the sale or lease of the products referred to in this interrogatory on a calendar year *or on any other basis.*
>
> * * *
>
> *IBM does not maintain accounting records sufficient to permit it to answer this interrogatory insofar as it relates to total costs and total profits* (emphasis added).

[27] Professor Sullivan puts it this way: "As the authors [Areeda and Turner] define it (and as logically they must, given their purposes) the concept of average cost includes a 'normal' return on investment. Once that is recognized the apparent precision of the test vanishes. A board with legislative authority and its own staff of economists and accountants might come to a plausible judgment about a normal return for any given industry. It does not at all follow that such a judgment could be reached through a jury trial, or even a trial to the court without a jury. It is not just that opportunities for obfuscation would be unending. It is also that inquiry into the issue in an advocatory context would lead to deeply-felt and tenaciously-held, yet conflicting, views, each espoused by an earnest expert and supported by regression studies—views which a judge or jury would often have grave difficulty in choosing between." L. Sullivan, *Antitrust* 110 (1977). *See also* Flynn, *supra* n.16 at 72-73.

D. Piecemeal Adjudication Of The IBM Section 2 Cases Has Led To Erroneous Perceptions And Fostered Bad Law.

The IBM Section 2 cases have been time consuming and expensive. Because of the economics of suing a well financed, seasoned antitrust defendant, Telex and CalComp traded off meaningful discovery for early trial dates. As a result, later trials have been governed by prior decisions where incomplete records permitted erroneous factual perceptions. For this further reason, we urge that the important Section 2 issues raised by Memorex's petition be decided along with Transamerica's case, with Transamerica's record built around IBM's claimed profitability.

The erroneous "facts" to which we refer are of special significance. *Telex,* the first tried IBM Section 2 case, went to trial less than fifteen months after its complaint was filed. The Tenth Circuit's reversal of the district court's finding of liability had an obvious impact on the later-decided cases. There, as in all the follow-on cases, IBM's Fixed Term Plan ("FTP") was central to an understanding of IBM's conduct directed at its peripherals competitors. With FTP (announced May 1971), IBM put selective products facing competition under one and two-year leases (in contrast to the thirty-day rental periods offered previously) and cut prices by 8% and 16%. These cuts were in addition to earlier disguised and discriminatory price cuts of over 27% for certain disks and up to 36% for some tape drives.

IBM defended against the characterization of FTP as a price cut by representing to the *Telex* district court, to the Tenth Circuit, this Court, and the *CalComp* trial court that the products offered under FTP were expected to generate "reasonable" profits of at least 20%. After the initial judgment in the *Telex* case, IBM had moved to add a finding, accepted by the court after no opposition by Telex, that "at the announcement of FTP it was anticipated that the profitability of the products to which it applied would be at least 20%."[28]

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[28] Finding 111a in *Telex Corp.* v. *IBM Corp., supra,* 367 F.Supp. 258, 306.

There is no doubt that the Tenth Circuit understood, and reasonably so, that IBM was representing that the products under FTP, including the very disk and tape products actually litigated in *Telex,* were *each* expected to generate a profit of at least 20%. That mistaken understanding, clearly the result of IBM's representations, was central to exonerating IBM from liability:

> As to pricing, the trial court found it was used by IBM only to a limited extent, that is, within the "reasonable" range. The resulting prices were reasonable in that they yielded a reasonable profit. This "profit" the trial court found to be about 20 percent. Thus there is no use of price reductions by an economic giant to drop prices to a level where it is not receiving an adequate return and must instead rely on its reserves or other activities to continue producing and marketing the particular product. *Instead in the case before us, as demonstrated by the trial court's findings, the particular products of IBM here considered stood on their own feet as to financial returns.*[29]

Transamerica pursued the factual basis for IBM's representations about FTP. Discovery revealed that IBM *never* examined the profitability of *each* product offered under FTP. Instead, long after *Telex,* IBM admitted that it was only the *aggregate* of all products under FTP as a whole which were expected to be profitable.[30]

Misperceptions of the "profitability" of FTP continued after *Telex.* In *CalComp,* where plaintiff essentially did not contest IBM's profit claims, the panel found that "[t]he evidence at trial was uncontroverted that FTP price reductions

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[29] *Telex Corp.* v. *IBM Corp., supra,* 510 F.2d at 926 (emphasis added).

[30] The profitability of FTP *as a whole* is not, of course, the relevant issue. A manufacturer of Chevrolets and Cadillacs, when charged with unreasonably low or below-cost pricing of the Chevrolet, can hardly defend by claiming that both cars were "highly profitable"—when the facts are that the Chevrolets are below cost but the profits on the Cadillacs were sufficient to result in profitability *when viewed together.* In assessing any claim about the profitability of FTP, what is meaningful is the profitability of each of the relevant products.

were expected to return a profit of 30% of revenue before taxes."[31] Although the district court in *Transamerica* did not go that far, it did state that "Transamerica offered no evidence that FTP caused a decrease in the profits of any product."[32] Both courts were wrong, a fact shown most directly by the unequivocal report of IBM's chief financial officer in July 1971 that FTP would cost IBM $102 million "in lost profits" in 1972 alone. Another IBM projection showed that FTP would cause a net profit loss of over $670 million through 1976.

The statement that no evidence showed a decrease in any product's profit as a result of FTP is also shown to be wrong by the very financial analyses created by IBM prior to FTP's announcement. Those documents (also introduced in *Transamerica*), show on their face that 26 different disks and tapes were less profitable under FTP.

Pivotal to *CalComp* were the district court's findings, on the record before it, that FTP was a reasonable "response to competition" because of its stated belief that (1) absent FTP, PCMs would have taken *100% of IBM's peripherals business;* (2) FTP was no different from what the PCMs offered; and (3) IBM, in adopting FTP, chose the least exclusionary alternative.

Transamerica's record shows that each of these *CalComp* beliefs is false.[33] First, as to the PCMs' taking 100% of IBM's peripherals business, IBM studies showed that its fall 1970 actions (the first of IBM's exclusionary actions aimed at its peripherals competitors) had seriously jeopardized the PCMs and that *at best* the PCMs might capture as much as 20% of the market over the next several years. In addition, IBM's Chairman at the time FTP was announced admitted at trial that he never believed the spurious FTP forecasts depicting that the PCMs would capture all or nearly all of the peripherals markets absent FTP. IBM's current Chairman Cary admitted the same thing.

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[31] 613 F.2d at 741.

[32] 481 F.Supp. at 1001.

[33] Space limitations preclude us from doing more than touching upon the facts in our record that demonstrate the falsity of the *CalComp* panel's beliefs.

Second, while a company with monopoly power may not defend on the basis that "everyone else was doing it,"[34] nonetheless the assumption that FTP was the same as the PCM leases is also false. IBM's FTP represented a marked departure from the PCM leases:

—Nearly all PCM customers had one year contracts or less—unlike IBM's two-year FTP.

—FTP discounts were substantially greater than those available from the PCMs.

—PCM leases either had no termination penalties, or the penalties were not enforced—unlike IBM's punitive cancellation penalties which were expressly set to lock users into their FTP leases.

—IBM, with FTP, undercut the PCMs' prices on many products, even taking into account any concessions PCMs may have offered.

With FTP, IBM did not simply *meet* PCM competition, it *beat* it—at a time when IBM already had 80-90% of the markets involved.

Third, IBM did not choose the least exclusionary alternative open to it in adopting FTP. Since an important part of the Section 2 "unnecessarily excludes" test requires examination of the necessity for acting and, importantly, whether the firm rejected less exclusionary alternatives, Transamerica introduced uncontradicted evidence—ignored by the district court—that IBM knowingly rejected less exclusionary alternatives in favor of FTP. This evidence had not been elicited at the time of the *CalComp* trial, or even the *Memorex* trial. The evidence came from the highest sources at IBM, Cary and former Chairman Watson.

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[34] It is well settled that unlawful monopoly-maintaining conduct may very well consist of acts and practices that would be lawful, even desirable, if undertaken by a firm without monopoly power. *Alcoa, supra*, 148 F.2d at 431; *United Shoe, supra*, 110 F.Supp. at 344-45; *Greyhound, supra*, 559 F.2d at 498; *Purex Corp., supra*, 596 F.2d at 888; *Sherman, supra*, 601 F.2d at 454.

Watson testified that at the time IBM announced FTP, IBM had available to it a host of other ways to compete against the PCMs:

> You are suggesting to me that the IBM Company in this particular situation had no other alternative than to adopt a long-term leasing plan in coping with this particular problem, and this is not the fact. If there were previous IBMers that testified that this was our only alternative, they have been wrong in their testimony.

Watson listed the alternatives, which included the announcement of technologically superior products, the commitment of more funds to research and development, improved marketing techniques, improved service and maintenance, and "lots of others." Cary, President of IBM and a member of IBM's top management committee when FTP was announced, again confirmed Watson's testimony.

The above examples are illustrative of what happened in the IBM Section 2 cases—expensive, time-consuming and hard-fought discovery produced incomplete records which in turn spawned half-truths and erroneous perceptions. The *Telex* and *CalComp* appellate courts, acting on the records before them, accepted IBM's "we were always profitable and just doing what others were doing" defense. Those courts had no real opportunity to examine IBM's assertions more closely. By the time *Memorex* came to the Ninth Circuit, the die had been cast. In the process, a now-discredited law review proposal had become the exclusive test of *per se* legality with no record before the courts permitting thoughtful examination of the assumptions implicit in the test.

That Section 2's prohibition of monopolization and the significance of the monopolist's intent got lost is an understatement. When the *CalComp* panel decision came out on the eve of closing agrument in *Transamerica* and the jury instructions were revised, Transamerica's entire case suddenly turned on IBM's profitability. Under the *Transamerica* court's instructions, IBM had it both ways. If IBM projected profits, it was exonerated. And if IBM's actions turned out to be profitable,

no matter what it actually anticipated, IBM was likewise exempt from Section 2 liability.

For Section 2 law to have strayed so far from the standards of *Alcoa, United Shoe* and *Schine* demonstrates the danger of the piecemeal appellate review of these cases. Accordingly, we urge this Court to decide the important Section 2 issues presented by these cases with the benefit of Transamerica's record. The future of Section 2 law should rest on no less than an opportunity to examine the most complete record available.

IV.

CONCLUSION

For the foregoing reasons, Transamerica respectfully submits that this Court should (1) grant the writ sought by petitioner Memorex, and (2) defer further proceedings until Transamerica's case reaches the Court.

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Respectfully submitted,

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